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The Honorable Michael E. Fryzel
Chairman, National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314-3428

The Honorable Rodney E. Hood
Vice Chairman, National Credit Union Administration

The Honorable Gigi Hyland
Board Member, National Credit Union Administration

**Re: Comments on the Advanced Notice of Proposed Rulemaking for Part 704**

To Chairman Fryzel, Vice Chairman Hood, and Board Member Hyland:

**1. The Role of Corporates in the Credit Union System**

Over the last thirty years, corporate credit unions (CCUs) have played a significant role in providing treasury, correspondent, liquidity/credit, investment, and other ancillary services (such as ALM and investment advisory) for their natural-person credit union (NPCU) members in an efficient and cost-effective manner. Prior to the development of the CCU network in the late 1970's, NPCUs had no or few providers of the full array of these services due to their relative small size. Many NPCUs (particularly small and medium-sized NPCUs) still rely extensively (and in some cases exclusively) on CCUs for the provision of these services. Thus, the role of CCUs in the Credit Union System remains as important today as it ever has been (and possibly even more so) and it is important that the CCU System be retained and enhanced.

***Payment Systems***

**Payment systems <u>should not</u> be isolated as a separate charter.**

The credit and liquidity management aspects of the payment system function can best be managed by a CCU as an on-balance sheet item provided that the CCU has appropriate credit and liquidity risk management programs in place. Few, if any, operating efficiencies would be gained if payment systems were under a separate charter. Further, if under a separate charter, the clearing aspect of payment systems would have to be either through the parent CCU or a third-party financial institution. Either way, credit and liquidity risks (and operational risk if through a third-party) would still have to be managed, and these tasks can more effectively be managed if payment systems resides in the CCU.

***Liquidity and Liquidity Management***

**Liquidity is an important (perhaps the most important) core function that CCUs provide to their member NPCUs and its role should not be diminished.**

For most NPCUs, CCUs are their only reliable outside credit source since these NPCUs are not members of either the FHLB or Federal Reserve Systems and their access to bank credit and non-member deposits is both limited and expensive. Through efficient liquidity management and economies-of-scale in the intermediation of credit with external funding sources, CCUs can best fulfill the liquidity role for their member NPCUs.

**CCU liquidity management should be done on a cash flow GAP basis rather than on a duration GAP basis.**

Matched (i.e., near zero balance) overnight, seven-day, 30-day, 60-day, 90-day, 120-day, 150-day, and 180-day interval and cumulative cash flow GAPs ought to be maintained without relying on either external borrowings or security sales. Duration GAP matching at these intervals can result in material cash flow GAP mismatches that could impair a CCU's liquidity and crucially impact the CCU's ability to fulfill the liquidity management function for its member NPCUs.

**Twelve-month forward cash flow forecasts need to be performed on a monthly basis for both expected and stressed liquidity scenarios.**

**Both matched cash flow GAP limits out to six months and 12-month forward cash forecasts on a monthly basis are advised to be mandated in Part 704.**

Although a CCU should not be dependent on external borrowings to achieve its liquidity management function, reliable (FHLB and Federal Reserve) external credit lines (including bank, commercial paper and repo) need to be maintained and managed for contingency purposes. Volatility in credit spreads should not be an issue if liquidity management is performed on a matched cash flow GAP basis since security liquidations prior to maturity should not be needed for liquidity management purposes.

**Restrictions and limits on illiquid investments should be addressed in Part 704.**

**CCUs should have access to borrowing directly from the CLF for contingency purposes. The timeframe for this borrowing authority should be extended through December 31, 2014. Additionally, the CU SIP program should be enhanced by both increasing the spread to NPCUs from 25 to 50 basis points and extending the program through December 31, 2014.**

***Fields of Membership Issues***

**National fields of membership (FOMs) for CCUs should not be withdrawn.**

While national FOMs have encouraged competition among CCUs in attracting term share certificates with the attendant growth (and risk taking), this growth can best be controlled by imposing higher capital requirements on CCUs. Given that the current national credit crisis has and will continue to deplete capital from the CCU System (for example, pending impairment of the 26 retail CCUs' contributed capital at U.S. Central FCU will deplete approximately 65% of retained earnings and 33% of total capital in the entire retail CCU System), it is clear that capital constraints will result in a much smaller retail CCU System having aggregate total assets in the $25-$30 billion range (compared to about $70 billion at the end of 2008) with fewer than ten retail CCUs remaining. This scenario suggests that significant attrition through either merger or liquidation will occur in the CCU System in the near future, so it important that CCUs have national FOMs so that NPCUs have choices (and in the case of liquidated CCUs, any choices) on a CCU that they can join. Restricting FOMs on either a regional or state basis is not advised since it would result in a large number of smaller CCUs operating with low economies of scale and scope.

***Expanded Investment Authority***

**Expanded investment authority should be retained provided CCUs : (a) practice appropriate credit risk management and ALM processes, have in-house investment expertise in terms of both breath and depth, and utilize the proper monitoring and control systems; and (b) maintain higher capital requirements.**

It would be almost impossible for CCUs to effectively create investment products (both overnight and term) and hedge risk positions without having both derivative and expanded investment authority.

**In Appendix B of Part 704:**

**(a) eliminate Base-Plus (not significantly different from Base authority), Part II ( i.e., no NRSRO long-term investment ratings below A-), and Part III (i.e., no foreign investments or counterparties);**

**(b) in Part I, lower aggregate investments in repurchase and securities lending agreements with any one counterparty to 200% of total capital and in Part 704.6(c)(2)(i), reduce this aggregate limit to 100% of total capital; and**

**(c) in Part IV, add a derivative counterparty exposure limit of 4% of total capital per counterparty and an aggregate derivative counterparty exposure limit of 10% of total capital, and require domestic counterparties only having long-term NRSRO ratings no lower than A-.**

***Structure: Two-Tiered System***

**The two-tiered system should be eliminated since retail CCUs of the future will be large enough not to need the services of a wholesale CCU.**

The two-tiered system that has existed since the inception of the CCU System has resulted in a sub-optimally large number of small retail CCUs that have in effect become branches of the one wholesale CCU. This structure has led to system inefficiencies and a significant system risk concentration in the wholesale CCU.

## 2. Corporate Capital

Core capital as defined in Part 704.2 adds permanence to a CCU's capital structure and it is analogous to Tier 1 capital at other federally regulated financial institutions. It is the only form of CCU capital that is recognized by NRSROs. Core capital is comprised of a CCU's retained earnings and contributed capital in the form of paid-in capital (PIC) as defined in Part 704.2 and meeting the conditions of Part 702.3(c).

Membership capital as defined in Part 704.2 is a component of a CCU's total capital, however it lacks permanence due to its three-year minimum withdrawal notice period and it not recognized either as capital by NRSROs or as Tier 2 capital by other federal financial regulators.

Total capital is the sum of core capital and membership capital.

The rapid asset growth (and attendant risk taking) of CCUs in recent year would have been abated if CCUs had operated under higher capital requirements, particularly core capital.

**Capital requirements at CCUs need to be boosted. All CCUs should be required to maintain a minimum 4% core capital to net asset ratio and a minimum 6% total capital to net asset ratio. If the CCU has expanded investment authority, the minimum total capital to net asset ratio should be 7%.**

The numerators of these ratios should be month-end amounts and the denominators should be moving daily average net assets (DANA) with net assets and DANA retaining their current Part 704.2 definitions. Given the volatile seasonality of CCU deposit flows, a 12-month moving average calculation for DANA is appropriate.

**A certain level of contributed capital in the form of both PIC and membership capital should be required for NPCUs and other entities seeking either membership in or services from a CCU.**

**Part 704.3(b)(1) needs to be amended to include a sentence that reads: "*A corporate credit union will condition membership, services, or prices for services on a credit union's ownership of membership capital.*".**

**Part 704.3(c)(6)(i) needs to be amended to read: "A corporate credit union *will* ~~may not~~ condition membership, services , or prices for services on a credit union's ownership of paid-in capital.".**

**In addition to these capital requirements, CCUs should be subject to new minimum core capital to risk-weighted net asset and total capital to risk-weighted net asset ratios similar to minimum Tier 1 and a combined Tier 1 and Tier 2 capital to risk-weighted asset ratios that are mandated for other well-capitalized federally regulated financial institutions.**

The numerators of these new ratios should be month-end amounts and the denominators should be 12-month moving daily average risk-weighted net assets (DARA). Given the volatile seasonality of CCU deposit flows, a 12-month moving average calculation for DARA is appropriate.

**Given that CCUs will be operating below these capital requirements (particularly for the core capital to net asset ratio) for some time, three to five years would be an appropriate timeframe for CCUs to attain sufficient capital at all levels.**

*Core Capital*

**CCUs should be required to maintain a minimum 4% core capital to net asset ratio.**

**In order to place a high emphasis on generating core capital through undivided earnings, CCUs should be required to maintain a minimum operating return on net assets (ROA) of 20 basis points until all capital ratios (core, total, and risk-weighed) are maintained at minimum levels.**

The numerator of operating ROA is the sum of net interest income (including equity transfer for PIC dividends), fee income, and miscellaneous operating income less operating expenses and it excludes investment gains/losses, gain/loss on disposition of fixed assets, gain/loss on hedged transactions, other non-operating income/expense, gain from bargain purchase (merger), minority interest, extraordinary items, and cumulative effect of change in accounting principle.

**A certain level of contributed capital in the form of PIC should be required for NPCUs and other entities seeking either membership in or services from a CCU.**

*Membership Capital*

**The minimum withdrawal notice period for membership capital should be five years.**

Membership capital currently lacks permanence due to its three-year minimum withdrawal notice period. If the minimum withdrawal notice period for membership capital were five years, it would be recognized as capital by NRSROs and as Tier 2 capital by other federal financial regulators.

**A certain level of contributed capital in the form of membership capital should be required for NPCUs and other entities seeking either membership in or services from a CCU.**

**The requirement for membership capital should be based on a NPCU's or any other entity's total assets and the adjustment period should be annually.**

**There should be <u>no downward adjustment</u> to the membership capital requirement due to a reduction in a NPCU's or other entity's total assets from one adjustment period to another.**

***<u>Risk-Based and Contributed Capital Requirements</u>***

**In addition to core and total capital requirements, CCUs should be subject to new minimum core capital to risk-weighted net asset and total capital to risk-weighted net asset ratios similar to minimum Tier 1 and a combined Tier 1 and Tier 2 capital to risk-weighted asset ratios that are mandated for other well-capitalized federally regulated financial institutions.**

The numerators of these new ratios should be month-end amounts and the denominators should be 12-month moving daily average risk-weighted net assets (DARA). Given the volatile seasonality of CCU deposit flows, a 12-month moving average calculation for DARA is appropriate.

**The requirement for contributed capital should be based on a NPCU's or any other entity's total assets and <u>not</u> on either share balances maintained at a CCU or any other criteria.**

**3. Permissible Investments**

**CCUs should have investment authorities beyond those allowed for NPCUs under Part 703.**

It would be almost impossible for CCUs to effectively add value in creating overnight and term investment products without investment authorities beyond those permitted in Part 703. However, if CCUs employ these extended authorities, it is imperative that they practice appropriate credit risk management and ALM processes, have in-house investment expertise in terms of both breath and depth, and utilize the proper monitoring and control systems.

**Foreign investment activities and the use of foreign counterparties should be prohibited. Consequently, in Appendix B of Part 704, Part III should be repealed.**

Foreign investments possess exchange rate risk that may be difficult to hedge in a highly volatile international market environment and many of them fall outside United States regulatory authorities and the United States legal system. Credit risk management and concentration limits on other investment activities should be addressed in CCUs' investment policies.

## 4. Credit Risk Management

**CCUs should use two NRSRO credit ratings when evaluating investments and counterparties, and employ the lower credit rating in meeting the minimum rating requirements in both Part 704 and a CCU's investment policy.**

It is highly likely that NRSRO ratings will be much more conservative and rigorous than they have been in the past. However, CCUs should not rely solely on NRSRO ratings. They should have sufficient in-house expertise and internally employ an appropriate credit risk modeling system that is capable of analyzing stress scenarios at the time of purchase and periodically thereafter. Third-party validation of this system needs to be conducted at least annually.

**In order to enhance diversification, exposure limits (both individual and, when appropriate, aggregate), expressed as a percentage of a CCU's total capital, ought to be addressed in Part 704 and required in a CCU's investment policy on: types of investments (e.g., CDOs, asset-backed securities, corporate debt obligations, etc.); issuers/obligors, sectors (e.g., non-agency residential mortgage-related securities, credit card asset-backed securities, etc.); individual securities (i.e., CUSIPs) according to NRSRO ratings; and counterparties having minimum long-term NRSRO ratings no lower than A-.**

The following are select example exposure limits expressed as a percentage of a CCU's total capital.

Investment repurchase agreements: 800% aggregate, 200% per counterparty.

Derivative counterparties: 10% aggregate, 4% per counterparty.

Alt-A mortgage-related securities: 25% aggregate, 8% for AAA rated CUSIPs down to 2% for A rated CUSIPs.

## 5. Asset Liability Management

**A new net economic value (NEV) volatility metric needs to be employed to assess rate risk embedded in a CCU's balance sheet. The proposed metric is the rate-change scenario's percent change in NEV divided by base total capital. The maximum volatility in base NEV for +/-300 basis point instantaneous, permanent, and parallel shifts in the yield curve is recommended to be minus 25%. There should be no limits on either base or post-shock NEV ratios.**

Current market dislocations and historically high credit spreads have rendered the traditional base NEV, base NEV ratios, and post-shock NEV ratios worthless as a means to assess a CCU's interest rate risk. Negative base NEVs resulting from these conditions more aptly measure potential credit risk exposure than rate risk exposure. In fact, the resulting negative base NEVs mask rate risk exposure. This new metric is independent of these conditions and more accurately depicts NEV volatility relative to a CCU's base total capital. Testing conditions mandated in Part 704.8(d)(2) should be retained and NEV testing should be conducted on a monthly basis.

**In addition to NEV analysis, CCUs need to perform 12-month forward income simulations for expected and stressed rate scenarios. Base net interest income should not decline more than 33% for these scenarios.**

While NEV (if properly specified) provides a reasonable measure of a CCU's long-term rate risk to capital, income simulation provides a better measure of a CCU's short-term risk to earnings.

1661

## 6. Corporate Governance

**CCU directors ought to be member NPCU elected representatives. Neither outside directors nor compensation for CCU directors is advised.**

In the cooperative spirit of the Credit Union System, it would seem that only member NPCU elected representatives should be able to serve as CCU directors. It is also clear from recent events in the credit markets that outside directors and compensation for directors have not resulted in any improvements in corporate governance. In fact, they may have promoted moral hazard in some instances.

**Term limits are not advised for CCU directors.**

Respectively submitted,

Charles R. Idol, Ph.D.